



May 20, 2002

Mr. Richard J. Williams
Director of Economics & Finance
State Corporation Commission
P. O. Box 1197
Richmond, VA 23218-1197

Dear Mr. Williams:

Thank you for your letter of April 24, 2002 requesting comments for the Commission's second annual report to the Legislative Transition Task Force ("LTTF") and the Governor under § 56-596 B of the Virginia Electric Utility Restructuring Act ("Restructuring Act" or "Act"). Section 56-596 B provides a mechanism by which the LTTF, the Governor and the Commission can monitor the status of competition in Virginia's electric utility industry. Appalachian Power Company, d/b/a American Electric Power ("AEP" or "Company"), welcomes the opportunity to assist the Commonwealth in promoting competition and appreciates the invitation to respond to your letter.

Section 56-596 B requires the Commission to report to the General Assembly and the Governor on three matters: (1) the status of competition in the Commonwealth; (2) the status of the development of regional competitive markets; and (3) recommendations to facilitate effective competition in the Commonwealth as soon as practical. In addition, your letter contains more

specific questions about various matters. The Company provides in this letter a general response to the provisions of the statute and to your letter.

A. RESTRUCTURING ACT TRANSITION

As the Company noted last year, the Restructuring Act establishes the market model for the electric utility industry in Virginia. The model consists of retail customer choice of generation supplier; continued regulation of transmission and distribution; and separation of the formerly integrated generation, transmission and distribution functions of the incumbent utilities. Under the model, competition in generation supply at retail is expected to evolve during a transition period extending to July 1, 2007. During this transition, robust generation markets are expected with capacity of both new entrants and incumbents competing in those markets.

The Restructuring Act represents a delicate balance of this retail choice model with other transitional and customer protection provisions. For example, capped rates until 2007 and default service for customers that do not choose an alternative supplier are major features of the Act. Moreover, recognizing the time needed for the restructuring to be put in place, the General Assembly allowed a two-year period, 2002-2004, during which to phase-in retail choice.

The General Assembly did not expect that all customers under the Act would necessarily even have a right to choose until 2004. However, AEP is ahead of this schedule in Virginia where all of its customers became eligible to choose on January 1, 2002. The Commission applied provisions of the Act to defer the right to choose of many of Dominion Virginia Power's customers and all of the

customers of the Electric Cooperatives and Kentucky Utilities. It is clear that both the Act and the Commission contemplate an evolutionary development of competitive generation supply, not an explosion of choice and competition immediately after January 1, 2002.

In addition to consumer protections such as capped rates and default service, other essential provisions of the Act provide protections during the restructuring process for other stakeholders in the electric industry. For example, incumbent utilities are entitled to recover stranded costs through the capped rate and wires charges provisions of the Act. Removal of wires charges from the Act has been recently suggested, primarily by competitive generation providers, without regard for the fact that the economic impact of wires charges on an individual customer's choice of generation supplier has been accepted from the initial adoption of the Act. The General Assembly originally concluded that those transitional effects did not justify excluding wires charges from the balanced provisions in the Act. Although retail generation suppliers have not yet begun to enter the market in Virginia, the construction of generation facilities suggests that the generation supply that would accommodate a competitive retail market is growing. It is premature to consider wires charges an impediment to competition that need to be removed from the Act immediately.

The Restructuring Act also contemplates adoption of rules on a number of subjects and other substantial Commission regulatory involvement in implementation of retail choice. Some rules are necessary, but the General Assembly has made its intent clear in that respect. In all of its proceedings, § 56-

596 A requires the Commission to consider “the goals of advancement of competition and economic development within the Commonwealth.” The purpose of all of the authorities given the Commission by the Restructuring Act is to further the new, market-based model established by the Act. The elimination of overly prescriptive rules and complex rule making procedures should be goals of the Commission in implementing the Act, both in initial rule development and as rules are revised.

Major features of the Act – phased-in retail choice, capped rates, default service, wires charges and Commission rule making – have been recognized as essential to maintain the correct balance between establishing competitive markets and an appropriate transition process to reach that result. Nevertheless, some of the questions in your letter imply that the Commission should begin to consider major changes in essential features of the Restructuring Act, ranging from eliminating wires charges and capped rates to adopting significantly different statutory provisions from other states’ laws. The Company respectfully disagrees that major changes should be made in the Restructuring Act at this point. The Commonwealth began its transition period only a few months ago on January 1, 2002, and retail choice has been intentionally deferred for a substantial number of Virginia’s electric customers until as late as 2004. Given the evolutionary concept of market development embodied in the Restructuring Act, it is too early to recommend fundamental changes in the Virginia restructuring process, particularly because some customers do not yet have a right to choose and the Commission has barely started its customer education process.

B. STATUTORY SUBJECTS OF THE COMMISSION'S REPORT

The remainder of this letter is organized to correspond to the three statutory subjects set forth in § 56-596 B of the Restructuring Act.

1. Status of Competition in the Commonwealth

Last year, the Company listed five mileposts passed in the implementation of retail choice under the Restructuring Act. A brief review of these mileposts outlines the status of retail choice in Virginia.

First, in 2001 the Commission established a schedule to phase-in customer choice in Virginia. As of January 1, 2002, all of AEP's Virginia customers have a choice of retail suppliers of electric generation services, and the Company stands ready to respond to customers' choices as alternative supply arrangements may become advantageous to them. Retail choice has not become available to some of the other electric customers in Virginia, including some of Dominion Virginia Power's customers and customers of the Electric Cooperatives and Kentucky Utilities, and may not become available to some of them until as late as January 1, 2004 under the rulings of the Commission.

Second, as expected last year, the Commission's customer education program is now underway, although it is at an early stage. The program appears to have had some effect in creating awareness of the existence of customer choice. However, customer awareness is evolving and customers have not yet been fully exposed to information that could both encourage and enable them to obtain new suppliers and services. Nor does the plan seem to focus on educating suppliers and aggregators as well as customers.

Third, since the Company's comments last year, the Commission has completed adoption of a number of rules governing retail choice and continues to re-examine them as appropriate. Among others, the Commission has undertaken rule making proceedings concerning general rules to implement retail choice (Case No. PUE-2001-00013) and minimum stay requirements for customers returning to incumbent utilities from a competitive service provider (Case No. PUE-2001-00296); rules governing applications for functional separation of incumbent electric utilities (Case No. PUE-2000-00029); rules with respect to consolidated billing (Case No. PUE-2001-00297) and competitive metering services (Case No. PUE-2001-00298); and rules establishing application requirements for certification of electric generation facilities (Case Nos. PUE-2001-00313 and PUE-2001-00665). Other rules are under consideration by the Commission. For example, a proceeding to adopt aggregation rules has recently begun (Case No. PUE-2002-00174).

Fourth, in 2001, the Commission had begun proceedings on the functional separation of incumbent investor-owned utilities and electric cooperatives. Those proceedings have resulted in the Company having functionally separated generation, transmission and distribution within its current corporate structure, while recognizing that the legal transfer of generation assets and functions into separate affiliated corporations is an additional step for the future.

The fifth milestone noted in the Company's comments last year concerned the establishment of RTOs, a subject discussed in the next section of this letter.

The implementation process envisioned by the Restructuring Act is proceeding. It is early in that process, and even as time passes, customers are protected by capped rates and the potential for regulated default service. Customers need not choose an alternative generation supplier immediately, and some of them cannot. They are protected if they do not change suppliers, however.

Demand for electricity in Virginia as a whole is in balance with the generating resources, including adequate reserve capacity, available to serve the demand. AEP provides its Virginia customers with electricity from several sources including generating capacity owned by the Company, and purchases from the AEP system, including an allocated share of purchases from non-affiliated generation suppliers.

In addition to the existing resources, substantial electric generating capacity that is planned or under construction would be available to serve customers in the relevant regional markets. Studies indicate that substantial capacity will be constructed in regional markets surrounding and including Virginia which will be available for use throughout those markets. It has been estimated that approximately 8,400 MW of capacity was added in those markets in 2001. For the period 2002-2007, it is estimated that about 87,000 MW of capacity could be added in the same areas. In Virginia, about 3,800 MW of capacity could be added during the 2002-2007 period. Such amounts of new capacity indicate that, at this time, there is no reason to project a deficiency of capacity in the regional markets that include Virginia.

However, Commission regulatory proceedings have resulted in controversy over the role of the Commission and other agencies in deciding environmental issues raised by the certification of new generation projects. Legislation was adopted in the 2002 Session of the General Assembly to address the roles of the individual agencies involved. The regulatory uncertainty surrounding power generation projects in Virginia has increased as a result of the controversy and remains to be resolved.

The Company also reported last year that it had obtained Commission approval of a large transmission line through its service territory that would improve reliability and promote wider availability of generation to other areas of Virginia. Recently, the draft environmental impact statement of the U. S. Forest Service has indicated that the federal authorities will also approve the line. However, the Commission has also recently agreed with Dominion Virginia Power that a transmission line formerly proposed by Dominion to connect to the AEP line need not be constructed at this time. Uncertainty about the removal of transmission constraints into Dominion's service territory may be created by that decision.

Although the Commission's Energy Choice Web site continues to list a number of licensed energy providers and aggregators, the Company's information is that there are currently no competitive energy suppliers soliciting customers in its service territory in Virginia. On the other hand, the Commission's customer education program, while progressing, has not yet reached a stage at which customers have been fully exposed to all of the information that would enable

them to solicit or accept offers from generation suppliers or aggregators in an informed manner.

There have been suggestions by some that the Commission's customer education program should be terminated or scaled back because there has been little solicitation of customers by competitive energy suppliers. After the long history of customer reliance on a single provider of electricity supply, there will likely be no successful customer choice program without customer education. The early message of the program has been effective in making customers aware of the existence of retail choice and giving them sources for general information. However, it has not reached a stage in which all Virginia customers have been fully exposed to all of the information that would encourage them to search out competitive offers. The program must become broader and continue through the transition period established in the Act.

The extent to which Commission rules might have discouraged entry is unclear, but several of the questions in your letter imply that rules should be changed to encourage entry. For example, there are arguments that shopping customers should be able to return to the incumbent utility at a market-based rate and thereby avoid minimum stay requirements. The Company would disagree with this approach for customers that are currently subject to minimum stay requirements. Those requirements are designed to protect the local distribution company from seasonal gaming by customers and/or suppliers and to give the LDC some certainty in planning for the load it must serve. They are preferable to other approaches suggested by the questions in your letter.

In Virginia, at the present time, there are no minimum stay requirements for most customers. Virginia minimum stay requirements apply only to larger customers with demands of 500 kW or more per month. For AEP, this is only approximately 0.1 % of its Virginia customers and should be expanded to provide adequate protection against seasonal gaming. It is unlikely that changes to further relax the current Virginia minimum stay rule would provide any significant encouragement to competitive entry.

In previous Commission proceedings, it has been argued that the projected market price for generation developed by the Commission in establishing wires charges under §56-583 should reflect a retail market price rather than a regional wholesale price. AEP's load shaping methodology already adjusts wholesale generation prices for class-specific losses, load factors and peak and off-peak usage. These adjustments result in generation market prices that are on a comparable basis to the incumbent's generation rate paid by each retail customer class. Any further adjustment would be speculative and inconsistent with a comparison to AEP's generation costs. While such a rule might appear to create a margin between projected market price and an incumbent utility's costs, that margin would not likely result in appropriate choices by customers or encourage competitive entry.

Your letter also inquires whether there should be a regulatory role to promote demand side management measures. Demand side management measures pursued under regulation, in the Company's experience, have not proved to be cost-effective and have been largely phased out. There is no reason

to believe that demand side management will occur in a competitive environment unless it is cost-effective. Standard service and time-of-use rate tariffs remain available to customers who elect not to participate in selecting a competitive service provider. In the Company's view, the Commission should not attempt to regulate either to promote or to discourage demand side management functions since they would be better provided by the market.

Only a short time has passed since choice became available in the Company's service territory, approximately four months of the five and one half year transition process as set forth in the Restructuring Act. Although there have been no customers to date that have changed generation suppliers in the Company's service territory, there is no reason to expect that the entire evolutionary process envisioned by the Restructuring Act would occur in the first four months of choice. Indeed, the Commission's customer education program remains in its early phases, concentrating on basic customer awareness that choice exists rather than the manner in which a customer may choose an alternative supplier and the other more practical information that customers will need to begin to select alternative suppliers wisely. It remains too early to conclude that competition will not develop in Virginia unless the restructuring model contained in the Act is significantly changed.

2. Status of Regional Energy Markets

The remaining milepost noted in the Company's letter last year is the establishment of regional transmission organizations ("RTOs"). Open access transmission services and broad access to energy suppliers remain preconditions

necessary to allow robust competition to develop for Virginia electricity customers. RTOs, when fully established, will help to facilitate access to broader sources of power and will provide independent operation of the bulk power transmission system. RTOs should further facilitate competitive wholesale electricity markets and will therefore assist in the development of an effective retail market in Virginia.

Currently, AEP is required to provide non-discriminatory, open access to transmission over its system to all suppliers on the same terms as AEP companies are given access to the system, and AEP transmission rates are governed by FERC tariffs. Access to AEP transmission is administered by an independent third-party under requirements established by the FERC when it approved the merger of AEP with Central and South West Corporation. These measures are recognized as interim measures that will be replaced by transmission service provided and administered by a RTO.

AEP has worked for several years to establish the Alliance RTO. It appeared that the FERC had substantially approved the Alliance and that it would become operational by the end of 2001. Although the FERC has since changed course with respect to the Alliance, the agency has also strongly reaffirmed its commitment to regulating transmission services through RTOs in a manner that should, over time, facilitate even broader access to generation resources for Virginia customers. AEP is taking measures to complete the FERC process as efficiently as possible and consistently with the policy of the Commonwealth that requires participation of the Company in a RTO. It has recently announced that it

will seek to join PJM Interconnection, LLC, and expects to become fully operational within PJM and its energy market within a six to twelve month time frame. The Company believes that is sooner than AEP would accomplish full RTO participation by other means.

FERC is currently working to implement a standard market design (SMD) for wholesale markets across the country. A key part of the SMD is the existence of an energy market, which would be operated by the RTO. That energy market is expected to be voluntary, based on a competitive bidding process, and security-constrained. Other essential elements in FERC's proposal for a SMD include a single transmission tariff, a new transmission service (network access service), transmission rights, and market power monitoring and mitigation.

RTOs and a standard energy market (power exchange) are not the only elements of a robust, effective wholesale market. Other features of a vibrant wholesale market would include open access to transmission facilities, easy access to generation supplies, the presence of wholesale power suppliers, and regulatory certainty. Many of these features are already in place and help to support a competitive wholesale market in the region that includes Virginia. Fully functioning RTOs and a standard market design will simply assist in the further development of the already competitive wholesale markets.

The last element listed above – regulatory certainty – is a critical item that the Commission can help to assure. The Virginia market is in its earliest formative stages and regulatory certainty will assist its continued development during the statutorily-prescribed transition period.

3. Recommendations to Facilitate Competition

Section 56-596 B contemplates recommendations “to facilitate effective competition in the Commonwealth”. However, the Commonwealth continues to have an opportunity to observe changes in economic conditions and developing competition in energy markets before further changes in the balanced approach taken in the Restructuring Act are considered. Accordingly, AEP makes no legislative proposals at this time. It will, of course, provide any assistance requested of it to analyze any proposals that may be made by others.

Thank you again for the opportunity to provide the Company’s views in response to your letter of April 24, 2002. We look forward to further participation by the Company in the matter.

Sincerely,

A handwritten signature in black ink, appearing to read "Barry L. Thomas". The signature is fluid and cursive, with the first name "Barry" being more prominent.

Barry L. Thomas
Director, Regulatory Services VA/TN